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TO RUEHC/SECSTATE WASHDC 3789
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RUEHBJ/AMEMBASSY BEIJING 2592
RUEHBY/AMEMBASSY CANBERRA 1947
RUEHUL/AMEMBASSY SEOUL 4069
RUEHKO/AMEMBASSY TOKYO 5666
RUEHHK/AMCONSUL HONG KONG 6237
RUEHDN/AMCONSUL SYDNEY 0746
RUEHIN/AIT TAIPEI 6414
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TAGS: EFIN ECON ETRD EINV PGOV SN
SUBJECT: ANALYSTS UNCERTAIN ABOUT EFFECT OF MARKET
VOLATILITY FOR REGIONAL ECONOMIES

REF: JAKARTA 2234

¶1. (SBU) Summary: Singapore-based financial analysts believe market volatility could have real economic effects on Asia even though the region has limited exposure to the subprime mortgage and credit derivatives problems afflicting the United States and Europe. Central banks across the region this week have been intervening to shore up depreciating currencies as Asian equity and foreign exchange markets remain volatile. Analysts foresee the possibility that more indirect exposures could come to light and inflation caused by currency depreciations could lead to monetary tightening in some Asian countries, particularly Indonesia. Many traders and investors are hoping for a dramatic response by the U.S. Federal Reserve to stem the market decline, but most Asian-based economists are more sanguine due to Asia's strong economic fundamentals. If the volatility leads to a slowdown in U.S. demand for Asian exports, however, Asia may be in for more economic pain. End Summary.

Market Turmoil Hits Asia

¶2. (SBU) Asian markets finally blinked this week. Their bout of nerves stemmed from the dramatic volatility in the U.S. and European money markets caused by liquidity problems in the subprime mortgage and corporate paper markets that began around August 9. The results in Asia were not pretty: equity markets in Asia were off sharply on August 16, with Indonesia falling as much as 8 percent during the day and developed markets such as Singapore losing more than 4 percent of their value. Overall, the Morgan Stanley Capital Index of the market capitalization for stock markets in Asia excluding Japan dropped 18 percent from its July 24 peak through August 16, although it remains up year-to-date by 5.2 percent. The fact that Asian stocks have shown positive gain for the year has led some analysts to believe that hedge funds are selling Asian stocks to help make up for losses elsewhere in the world.

¶3. (SBU) Foreign exchange markets also took large hits, with many analysts noting that the sharp appreciation of the yen

(reaching 3 percent in 3 days) reduces incentives for so-called "carry trade" investments in high-yielding currencies such as the Indonesian rupiah. (Note: The yen carry trade involves funding investments in currencies earning high interest rates using the yen-denominated assets which have a low interest rate. While commentators often assume that these types of trades are mostly undertaken by hedge funds, in fact, Japanese households in search of better returns on their investments make up a significant portion of these trades. See Reftel Jakarta 2234. End note.)

Weak Linkages to Subprime Problems

¶4. (SBU) Regional banking analysts have told us that Southeast Asian financial systems have "very little" exposure to the U.S. subprime mortgage sector. They note that most regional banks are not sophisticated enough to "dabble in complex credit derivatives." Exposure in Indonesia, according to one official source, is non-existent among the major banks, although it is impossible to rule out inappropriate investments by smaller, private banks. Only one smaller bank admitted exposure in Thailand. Singaporean banks have the largest exposure in the region, with a total of S$2.3billion (US$1.5 billion) in total exposure to collateralized debt obligations (CDOs), the vast majority of which are still highly rated by credit rating agencies. Moreover, only S$0.6 billion (US$0.4 billion) of the Singaporean banks' CDO portfolio is related to mortgages -- the section of the market under pressure in the U.S. and Europe. One analyst estimated that writing off half of the mortgage related CDOs would only reduce the banks' estimated profit for 2007 by 5 percent.

¶5. (SBU) Singaporean banks admit that their asset management companies have approximately S$81.5 billion (US$53.6 billion) in third-party assets that are invested in CDOs, of which S$4.8 billion (US$3.2 billion) are mortgage-related products. While banks do not disclose who holds these investments, analysts presume these assets are widely dispersed and mostly highly rated, diminishing the risks for systemic problems.

¶6. (SBU) Sources speculate that non-bank financial companies may face more problems from the market turmoil than banks due to their higher subprime and credit market exposure. Insurance companies, for example, may have purchased these products. However, insurance companies would likely have purchased more highly rated tranches of credit derivatives and would typically hold these investments for the long term, thereby mitigating short term volatility risk. The closure of the corporate paper markets may affect finance companies that rely on debt (rather than deposits) to fund their lending activities. However, these finance companies could present some risk to financial stability to the extent that many of them are owned by banks. Whether this would have a systemic effect would depend on how large the finance companies were relative to the banks and how long the credit markets stayed closed, according to analysts.

Currency Moves Could Mean Inflation

¶7. (SBU) Media reports and market participants observed that many central banks in the region were intervening to defend their currencies. Most notably, Bank Indonesia, Bank Negara (Malaysia), and the Monetary Authority of Singapore (MAS) were cited in the press as selling their U.S. dollar reserves to prevent further depreciation. Rapid depreciation, if sustained, could lead to a surge in inflation. Analysts cited Indonesia as particularly at risk for inflation, and noted that the rise in the exchange rate to 9,500 rupiah per dollar significantly reduced the likelihood of further interest rate cuts for the rest of the year, something the central bank had been planning to implement. Only Thailand,

which faces increasing political pressure due to a rapidly appreciating currency over the last year, appears to welcome the devaluation pressures.

Money Market Stability

¶8. (SBU) In contrast to the foreign exchange markets, Southeast Asian interbank lending markets have not seen much volatility. Analysts noted, for example, that neither Singapore nor Indonesia had seen volatility in overnight interbank lending rates, suggesting that the excess liquidity in the banking sectors and lack of direct exposure to the U.S. subprime issues has translated into little if any increased risk in lending to Asian banks.

The Way Forward?

¶9. (SBU) Several analysts mentioned that investors were "praying for a Fed rate cut" to stem the slide and bail them out. They noted that the futures market was now pricing in a rate cut in the United States. Most Asian-based economists, however, contend that an interest rate cut -- especially an emergency cut by the U.S. Federal Reserve -- is unnecessary to stop the turmoil in Asian markets. They compare the current situation to previous bouts of instability in the emerging markets, in particular those that lasted 5 to 6 weeks in April, 2006 and February - March, 2005. Most analysts observed that it was probably good that investors were reconsidering the relative risk of their investments. In fact, as a result of the current turmoil, global risk appetite has had its largest shift in ten years, according to Merrill Lynch.

Comment

¶10. (SBU) Fundamentals in Asia are strong: most countries are running current account surpluses; banks are well capitalized and highly liquid; companies are not highly leveraged; central banks have the power to limit currency instability thanks to large FX reserves; growth is generally solid; and direct exposure to subprime issues appears low across the region. However, should the U.S. economy -- especially U.S. personal consumption -- weaken dramatically, there will likely be spillover affects on the real economy in Asia. The United States is, after all, the largest market for Asian exports.

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